Volume 32, No. 4, January 25, 2019

Quarterly Update

CWS Capital Partners LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

March 15, 2019
Year 2018 K-1's Mail by Date

April 15, 2019
2018 Federal & State Tax Filing Deadline
1st Quarter 2019 Est. Tax Payments Due

April 16, 2019
CWS Annual Partners Meeting
New Location
Irvine Marriott (Irvine, CA)

April 19, 2019
Good Friday
CWS Offices Closed

April 26, 2019
1st Quarter 2019
Quarterly Packages Mailed

May 27, 2019
Memorial Day
CWS Offices Closed

June 15, 2019
2nd Quarter 2019
Est. Tax Payments Due

July 4, 2019
Independence Day
CWS Offices Closed

July 26, 2019
2nd Quarter 2019
Quarterly Packages Mailed

www.cwscapital.com

Positioned Well For A Slowdown

By Gary Carmell

Warren Buffett has dramatically outperformed the market and his peers over his 50+ year investment career. This has been the case more so because of his performance during down markets rather than his performance during up markets. While others are heavily invested at the top and reeling from big losses and playing defense, he has had capital available when others did not and as a result, has been able to make great value investments. He has consistently been one of the few well-capitalized buyers in markets full of numerous and often desperate and fatigued sellers. He aggressively goes on offense in downturns and credits his outperformance to being greedy when others are fearful and fearful when others are greedy. As a result of this approach he has always cautioned his investors to expect underperformance when the markets were doing well but over the long term through full cycles they should expect him to outperform the market. In some ways we believe similarly to Buffett because when everything is going well and capital is flowing freely, money is relatively easy to make early on and everyone looks like a genius. But it's during these times that errors of optimism are made and the risk of losing one's capital increases. And this is when our antennae of caution start to go up.

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If we are doing our job and tapping into our experience and intuition, it is during these times of abundant capital and excess optimism that it is incumbent upon us to be a bit contrarian. This leads to sometimes having a different view of the future than others: One that is not as rosy. Sometimes people truly believe the markets are different this time and continue to ignore the signs and at other times they convince themselves of it because of the financial incentives they have to keep deploying capital despite the escalating risks. By keeping a clear head and having the financial strength and company culture to pull back when we believe that the risk-reward relationship is out of balance, we better position ourselves to go on offense when most of our competitors are on defense. And when we combine not being diverted by attending to too many problems along with having insight, courage, and access to capital to take advantage of the opportunities that are present towards the bottom of an economic cycle and subsequent recovery, then we position ourselves for generating very compelling returns.

Although we had our share of challenges in the wake of the Great Recession, we also had enough organizational capacity and terrific capital relationships built up over a long period of time to be able to take advantage of what turned out to be one of the great markets for apartment investors in recent memory. As a result, we delivered compelling returns to our investors for those investments that have come full cycle and for the ones that we continue to own we feel like our returns have been competitive on a risk-adjusted basis. They have also offered good diversification for investors as well as meaningful tax benefits.

Now that we are later in the economic cycle, and the apartment competitive landscape is fiercer with a significant amount of new development in many of the markets in which we operate, the question is how is CWS positioning itself going forward? We believe that the asset class should hold up reasonably well for reasons I will mention later and that our reliance on floating-rate loans will be an effective hedge against a slowing economy, and even more so if it begins to contract. And while our floating-rate debt has been a winner over the long-term, the recent Fed hikes have resulted in us giving back some of the interest rate savings we have accrued (in excess of $73 million since 2012). Like Buffett, however, this strategy will have its highest payoff in the event of a slowing or contracting economy.

We have been significant borrowers and advocates of floating-rate debt because of the starting rate advantage, the prepayment flexibility, and historically the cost of funds have been lower over a long period of time. So, in some ways, we have been getting a free lunch in terms of lower cost of funds and better prepayment flexibility. Such flexibility allows us to take advantage of unique windows when lenders are very hungry to originate apartment loans, especially to a quality sponsor such as CWS. An example of this was in 2015 when we refinanced 18 of our properties and we were able to significantly lower our cost of funds as measured by the spread over LIBOR. In addition, at least one of the properties that we sold, Hermann Park, we

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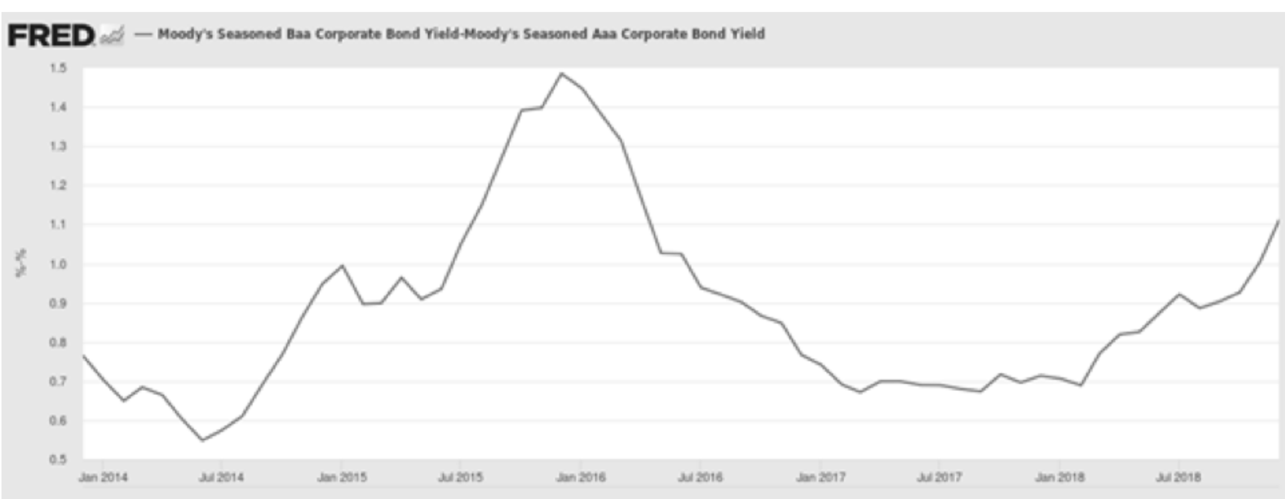
believe we obtained a premium price because the financing that we had available to the buyer to assume was far better than a new loan in the market in terms of leverage and cost. This was highly valuable to the buyer such that the price they paid was materially higher than others who submitted offers.

If you fast-forward to today we just completed 12 refinances that took place at the end of 2018 and we did this for a number of reasons. We believe that, as mentioned earlier, we are coming to the later stages of the economic cycle and that there are more risks on the horizon, particularly when it comes to the credit markets. Corporate America has fairly aggressively binged on low-cost debt and the terms and conditions of those loans have become more favorable to the borrowers such that credit conditions will probably start to deteriorate as the economy slows down. And we are seeing bond market investors pull back and lenders demanding higher yields for loans that they make even in the face of continued economic growth, so this is somewhat concerning that you're already seeing this pullback despite a decent economy.

The following chart shows an indicator I like to watch to convey the state of credit conditions. It shows the yield differential between lower quality Baa corporate bonds versus very high quality AAA bonds. When the spread is low, investors don't perceive much risk and vice versa when it is high. Currently it has been moving fairly significantly off of its bottom. We are still quite a bit from the recent cycle peak in December 2015 but it has moved up fairly aggressively since bottoming in February.

This indicator has led the stock market with the stock market bottoming in February 2016, two months after the spread peaked, and in this current cycle the stock market peaked in October 2018, approximately seven months after the spread hit its low point. I kept watching the divergence between credit quality deterioration as measured by widening corporate yield spreads and the stock market that kept going up knowing that one of them had to be wrong. It looks like it was the stock market.



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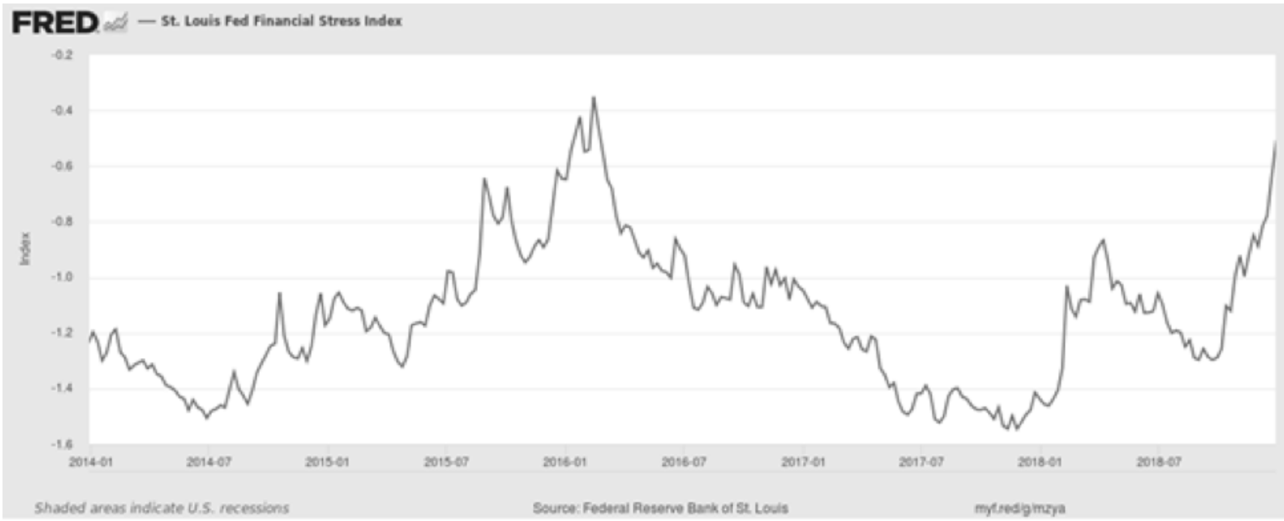
Despite yield spreads not being as wide as they were in late 2016, the financial stress index has approached similar levels as measured by the St. Louis Financial Stress Index.



The practical effects of this tightening up of credit conditions is that the economy may suffer as a result of corporations finding that the cost of debt is higher-than-expected and they have to cut back on capital spending and perhaps employment and this will have a ripple effect throughout the economy. Combine this with the Federal Reserve that the market believes has been now too aggressive in its monetary stance with increasing maturities of U.S. corporate debt over the next three years, and you have the makings of credit conditions becoming less favorable to borrowers.

Add to this the prospect of a new regulator for Fannie Mae and Freddie Mac, and we may have a set of conditions in which their market share is reduced and the capital that they can put out is constrained such that the cost of capital increases independently of wider corporate bond

Estimated Global Schedule for Maturing Corporate Debt Through 2021 (2017–2021)

(dollars in billions)

	2017	2018	2019	2020	2021	Total
United States						
Financials						
Investment grade	$232	$223	$209	$151	$159	$972
Speculative grade	25	22	24	312	6	127
Nonfinancials						
Investment grade	312	360	391	433	447	1,944
Speculative grade	49	140	241	329	405	1,164
Total United States	**$617**	**$745**	**$464**	**$944**	**$1,037**	**$4,207**

Source: S&P Global

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market effects. Combining all of this led us to believe that it was better to act now and somewhat aggressively to refinance those properties that had high spreads over LIBOR, were maturing relatively soon, were amortizing (or were about to) and the new loans could extend the interest-only periods, and qualified for enough proceeds such that no additional investor capital was needed to cover refinance shortfalls and ideally cover any significant capital expenditure needs the property had. And in a number of cases we were able to generate enough additional proceeds to distribute these dollars to our investors. The cumulative distribution resulted in excess of $29.6 million. As previously mentioned, we closed on 12 of them by year end and we are delighted by what was accomplished.

As I indicated earlier, over the last year or so we have given back a small portion of the interest rate savings with the increase in LIBOR. Despite this, the strategy has been beneficial as we have been able to sell properties with minimal prepayment penalties and capture a lot of value by not requiring buyers to assume our loans that had onerous prepayment penalties. In addition, we have also been able to refinance many properties in which the prepayment penalties were waived. As a result, the flexibility that has been created by this strategy has been tremendously accretive to our investors.

A number of our pro formas that we projected when we acquired our properties had LIBOR peaking at around 2%. Today it's about 2 1/2% so in retrospect we missed on this, although now there are indications that the Fed will probably be on hold as we are starting to see the yield curve invert in certain maturities which often foreshadows slower economic growth. Despite the recent strong jobs report, which I think had unusual seasonal adjustments and will be revised downward in the future, slowing growth seems to be corroborated with the trade tensions finally materializing in terms of lower economic output, particularly in China, which has effects across the globe, a slowing housing market, an auto market that is somewhat soft, and, as previously mentioned, credit conditions that are tightening.

The table below shows the probability of where the Federal Funds Rate will be over the next year. There is a greater than 50% chance that the Fed does not move but if it does then the

	MEETING PROBABILITIES																							
MEETING DATE	0-25	25-50	50-75	75-100	100-125	125-150	150-175	175-200	200-225	225-250	250-275	275-300	300-325	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550	550-575	57[illegible]
1/30/2019								0.0%	0.5%	99.5%	0.0%	0.0%												
3/20/2019						0.0%	0.0%	0.0%	3.1%	96.9%	0.0%	0.0%	0.0%	0.0%										
5/1/2019				0.0%	0.0%	0.0%	0.0%	0.0%	3.0%	95.0%	1.9%	0.0%	0.0%	0.0%	0.0%	0.0%								
6/19/2019		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2.9%	90.4%	6.6%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%						
7/31/2019	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	7.4%	86.1%	6.3%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%				
9/18/2019	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.3%	9.2%	84.2%	6.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%		
10/30/2019	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.9%	14.0%	79.2%	5.7%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0[illegible]
12/11/2019	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	2.6%	22.7%	69.5%	5.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0[illegible]
1/29/2020	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.6%	6.0%	30.5%	58.8%	4.2%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0[illegible]

Source: CME Group

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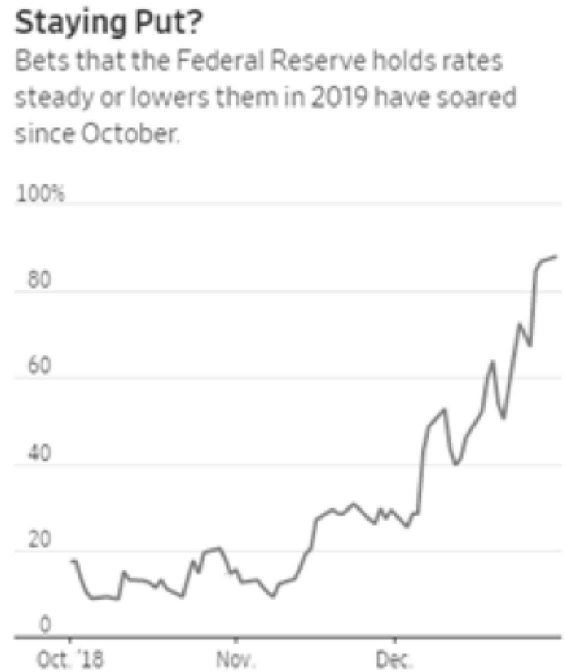
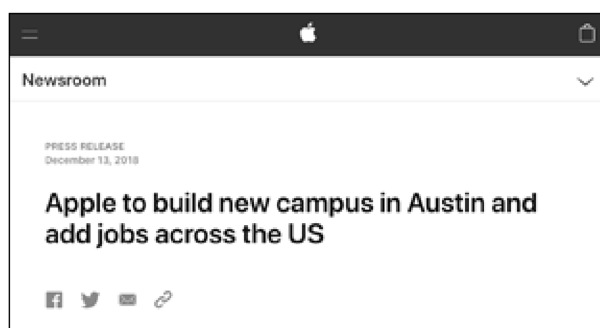
probabilities are now greater for the Fed cutting rates (approximately 37%) versus raising them (4.3%). Our budgets for 2019 reflect an average LIBOR rate that is approximately 0.25% higher than where they are today, so we feel pretty good about our debt service projections after a couple of years of having missed them due to the Fed being more aggressive than projected when we did our previous budgets.



Source: CME Group

So these are the sets of conditions such that we feel like we are relatively well positioned in terms of the portfolio of assets that we own, how they're financed, and where they are located. We think they should perform relatively well in a slowing or even somewhat contracting economic environment. We are in cities like Austin, Texas that just had a great announcement from Apple. They are going to make a $1 billion+ investment to expand their operations there and this is expected to result in 5,000 to 15,000 additional jobs. In addition to Apple, other large tech companies like Facebook, Oracle, Indeed, and HomeAway have announced significant expansions in Austin that should allow the city to cushion the blow somewhat in the event of a national slowdown. While of



1. https://www.apple.com/newsroom/2018/12/apple-to-build-new-campus-in-austin-and-add-jobs-across-the-us/

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course Austin, or virtually every other city, would not be immune to a national downturn, we do believe that cities with the growth characteristics of Austin should outperform on a relative basis.

We are also well positioned in terms of the asset class in which we are invested. I think there has been an underappreciation of the impact on homeownership that the new tax law changes will have with the doubling of the standard deduction and the limitation of $10,000 for state and local taxes, inclusive of property taxes. This hits high tax states like California and New York particularly hard. It also impacts a state like Texas. Although it has no state income tax, it does have very high property taxes so one can hit the $10,000 threshold just for property taxes. Renters no longer have to buy a home to obtain materially better tax benefits now that the standard deduction has doubled. And when this is combined with the curtailment of some deductions for homeowners, renting has become even more competitive on an after-tax basis, particularly if there is concern about future appreciation potential.

I think this is part of the reason housing has been slowing down and apartments have been doing much better than expected in terms of rent growth, despite the new supply and being at the latter stages of the economic cycle. Combine this with a heavy bias towards floating-rate debt in our portfolio, which should see a lower cost of funds as the economy slows down and weakens leading to the Fed eventually having to cut rates to offset the reduction in fiscal stimulus, headwinds from tariffs, and the tightening of financial conditions. We believe this positions our portfolio to benefit relatively well because of lower interest rates. It is especially magnified by having interest-only loans which can have a significant impact on our overall cost structure and can make up for rent deterioration or stagnation in the face of economic weakness. In addition, Texas, where we have the highest portfolio concentration, has property taxes that are somewhat variable in the sense that they really go up quite significantly when property values are going higher, but they also do eventually come down as property values adjust downward. So we have the prospect of two of our biggest costs, debt service and property taxes, potentially adjusting downward over the course of the weakening economic cycle.

Overall, we believe we are well positioned in the event of an economic slowdown or mild contraction and this should enable CWS to be in position to be on offense if and when more distress appears in the marketplace.